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Malaysia: Tilting at Foreign Economic Interests

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An Intelligence Assessment

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Malaysia: Tilting at Foreign Economic Interests [redacted]

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An Intelligence Assessment

Information available as of 1 March 1982 has been used in the preparation of this report.

The author of this assessment is [redacted] the Office of East Asian Analysis. Comments and queries are welcome and may be directed to the Chief, Malaysia, Singapore, Islands Branch, OEA, on [redacted]

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The paper was coordinated with the National Intelligence Officer for East Asia and with the Offices of Global Issues and Central Reference. [redacted]

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Malaysia: Tilting at Foreign Economic Interests

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Key Judgments

The economic success story of Malaysia is becoming a bit frayed. Almost inflation-free annual real growth of 8 percent during the 1970s has given way to weak export prices and a ballooning government budget. Last year the country experienced its first postwar merchandise trade deficit, and a deteriorating exchange rate pushed inflation into double digits for the first time since a short-lived surge in 1974.

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The aggressive new government of Prime Minister Mahathir is addressing its economic problems by taking aim at foreign investors, trading partners, international institutions governing commodity trade, and foreign governments. Since mid-1981, Malaysia has intervened in world commodity markets—reportedly with Kuwaiti financial assistance—to prop up prices for the country's exports, bought majority equity positions in several of the country's resource-based foreign firms, instituted a boycott of British goods, and bitterly criticized US positions on international commodity issues.

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Although Mahathir is a pragmatist who is unlikely to radically change Malaysia's liberal foreign investment rules, midyear national elections may force him into further anti-US posturing to convince voters that he is defending Malaysian interests. A turnabout in the economy that would moderate his frustrations with foreigners is unlikely in 1982.

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The Malaysian Leadership

Bangkok Post ©

Mahathir Mohamad
Prime Minister

Mahathir automatically succeeded to the presidency of the United Malays National Organization and thus the prime-ministership when Hussein Onn declined to be a candidate for reelection. Mahathir served as Deputy Prime Minister from 1976-81 and Minister of Trade and Industry during 1978-81.

Mahathir has earned a reputation as an able man of ambition and integrity. During his first six months in office, however, he has been accused by critics of "inexperienced overenthusiasm." He has:

- *Formally protested GSA tin stockpile sales.*
- *Blasted "reactionary forces" in the industrial world for Malaysia's economic woes.*
- *Begun a "look east" philosophy for foreign policy and development strategy modeled after Japan and South Korea.*
- *Criticized Western work habits and praised Japanese industriousness.*
- *Threatened to deny the United States the opportunity to buy Malaysian natural rubber for strategic stockpile purposes.*

Asiaweek ©

Musa Hitam
Deputy Prime Minister

The selection of Musa as Deputy Prime Minister in 1981 was viewed as a plus for Malaysian-US relations. Musa nevertheless is reportedly the architect of the Malaysian tin intervention scheme. Although normally willing to compromise on international commodity issues, he is strongly nationalistic. As Minister of Primary Industries during 1974-77, he spearheaded efforts among LDCs to formulate plans for international rubber price stabilization and stockpiling.

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Malaysia: Tilting at Foreign Economic Interests

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Recent Developments

Lacking large amounts of domestic capital, Malaysian administrations for three decades have welcomed foreign investors as a way of promoting national economic development. The country's dependence on exports, 57 percent of GNP in 1980, and the economy's relatively small size have meant that successive governments have played a passive role in dealing with foreign economic interests—investors, trading partners, and the private international banking community.

Since mid-1981 the picture has changed dramatically. A new government in Kuala Lumpur, eager to prove its mettle to a domestic political audience, seems determined to chart its own direction despite unfavorable global economic trends. Not surprisingly, the government, in dealing with outside influences, is exploiting the two sectors where Malaysia's role in the world economy is disproportionately large—tin and rubber production.

With such a strategy, collisions with Washington on commodity issues are clearly unavoidable. Key international commodity prices are largely determined in official forums such as the International Tin Council rather than in international markets, and the United States invariably votes as a consuming nation rather than as a producer. Whether Malaysia's new strategy will affect the substance of bilateral relations is still to be determined.

Effortless Growth in the 1970s

Malaysia, unlike many other nations of colonial heritage, adopted liberal rules governing foreign investment and pursued fiscally conservative, market-oriented economic policies during the seventies. Malaysia's resource base was ideally suited to a tightening world oil market and to expansive growth policies in industrialized countries. Rising international prices for natural rubber, tin, palm oil, and petroleum produced an impressive 8-percent annual average rate of growth, and the incidence of poverty was reduced by at least half. Discretionary price controls on key consumer goods and occasional export bans on steel, cement, and flour held inflation to a remarkably low 4.7 percent annually.

So buoyant were Malaysia's nonoil terms of trade that the government formulated an oil-production policy designed to conserve resources rather than generate revenues. Petronas, the state oil company, adopted artificially conservative estimates of oil and gas reserves and under its national depletion policy limited annual production to 1.75 percent of "official oil in place." Industry analysts pegged proved oil reserves at 2.6 billion barrels, substantially higher than the government did. With nonassociated gas reserves at 36 trillion cubic feet (6 billion barrels of oil equivalent), Malaysia's oil and gas reserves were unanimously judged sufficient to ensure its status as a net exporter of energy well into the 1990s.

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Malaysian administrations have been far more addicted to economic growth as a social palliative than most governments. Rapid growth has been essential in keeping a tight lid on the country's preeminent political problem—communal animosities among Malay, Chinese, and Indian ethnic groups. A collection of investment laws known as the New Economic Policy (NEP), instituted after serious racial rioting in 1969, assured economic gains for the politically dominant Malays by targeting 30 percent of corporate sector equity for Malay ownership by 1990—a planned increase of 700 percent.[1] The NEP also promised to reduce the share of foreign equity ownership, as opposed to the level of holdings, by at least half.

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[1] In 1971, foreign residents owned 62 percent of the Malaysian corporate sector. Bumiputras (ethnic Malays) held 4.3 percent, about half via government trusts.

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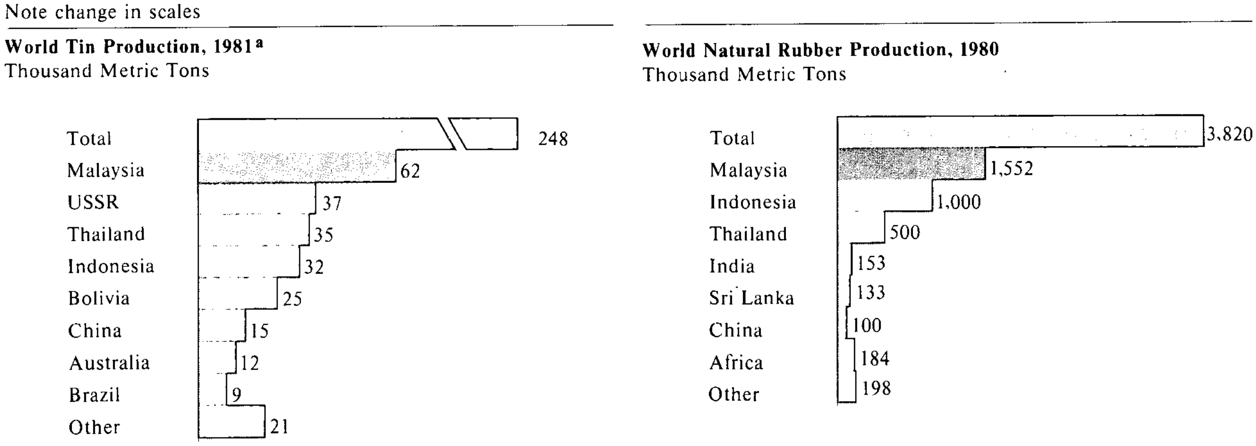
Figure 1

Malaysia: Global Economic Significance

Note change in scales



[a] Estimated.

[redacted] 25X1

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Kuala Lumpur has since had to delicately balance the concerns of the foreign business community with its own social objectives. The government—correctly as it turned out—counted on rapid economic growth to avoid absolute reductions in the holdings of the local Chinese community or foreign investors that would lead to reduced manufacturing investment. Capital outlays in the textile, footwear, and semiconductor industries helped expand Malaysia's exports of manufactured goods by over 50 percent in value each year between 1976 and 1980. [redacted]

The Success Story Starts Unraveling

Malaysia's 6-percent growth performance last year brought little domestic satisfaction as export prices dropped 11 percent on average and international purchasing power plummeted. Weakness in international markets hit tin miners—mostly influential ethnic Chinese—and rubber producers—mostly Malay smallholders—especially hard. Kuala Lumpur compensated exporters by allowing a 10-percent depreciation of the exchange rate, at the cost of boosting domestic consumer prices. Inflation at 12 percent moved into double digits for the first time since a brief surge in 1974. Simultaneously, government price ceilings produced politically unpopular food shortages in urban areas. [redacted] 25X1

Kuala Lumpur is implementing expansionary economic policies to maintain politically acceptable rates of growth. An ambitious new five-year development plan called for over $1 billion in project-related spending last year. Orders of foreign machinery for the oil and gas sector and purchases of aircraft and ships for state-owned commercial fleets boomed. Malaysia's external accounts slumped dramatically as imports expanded by 31 percent in the face of stagnating nonoil export earnings and slower growth of oil export revenues. The country recorded its first merchandise trade deficit ever and an equally unprecedented current account deficit of $2.6 billion. [redacted]

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Table 1 Million US $

Malaysia: Balance-of-Payments Summary

	1979	1980	1981 [a]	1982 [b]
Current account	1,047	−233	−2,650	−2,740
Merchandise trade	3,017	2,343	−50	300
Exports f.o.b.	**10,995**	**12,896**	**13,750**	**16,100**
Of which:				
Crude petroleum	1,560	2,827	3,567	3,620
Natural rubber	1,554	2,250	2,179	2,376
Tin	1,227	1,153	1,155	1,191
Palm oil	1,261	1,233	1,339	1,673
Logs and sawn timber	1,825	2,067	1,719	2,074
Imports f.o.b.	−7,978	−10,553	−13,800	−15,800
Service and transfers (net)	−1,970	−2,576	−2,600	−3,040
Capital account	**−228**	**700**	**1,972**	**2,012**
Of which:				
Official long term	327	141	977	943
Private long term	704	914	1,678	1,635
Short term [c]	−1,259	−355	−683	−566
Overall balance	**819**	**467**	**−678**	**−728**

[a] Estimated.
[b] Projected.
[c] Includes errors and omissions.

[redacted] 25X1

Kuala Lumpur has financed continued growth only by tapping all available sources of foreign credit. The Central Bank has run down international reserves by $800 million since late 1980 and secured $220 million from the IMF's Compensatory Financing Facility to replace export shortfalls.[2] Taking advantage of excellent international credit terms available to Malaysian commercial borrowers because of a previously strong balance of payments, the government-owned Bank Bumiputra has secured nearly $2 billion in syndicated foreign loans over the past 12 months. An October credit, reportedly the second largest ever secured by an Asian borrower, was oversubscribed at $700 million despite carrying the year's lowest spread in the region at 0.375 percentage point over the London Interbank Offered Rate. [redacted] 25X1

An Aggressive New Government

Kuala Lumpur's current economic policy reflects the influence of former Deputy Prime Minister Mahathir Mohamad, who became Prime Minister last July when ill health forced the resignation of Hussein Onn. Reputed to be a pragmatist favoring free trade and liberal foreign investment policies when he assumed office, Mahathir nonetheless carries the credentials of a Malay nationalist from his early political career. His pet project—under way since 1980—the Heavy

[2] Malaysia's international reserves stood at $3.7 billion as of October 1981, or roughly three months of import coverage. Central Bank officials consider this level insufficient because of Malaysia's open economy and traditionally large fluctuations in export revenues. [redacted]

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Industry Corporation of Malaysia, is designed to promote medium- and small-scale development for ethnic Malays by financing high risk ventures in the country's manufacturing industries. In addition, Mahathir is the architect of the 1981-85 development plan, which by planning $19 billion in expenditures under NEP guidelines is easily non-Communist Asia's most ambitious experiment in social engineering. [redacted]

Mahathir's approach to economic policy reflects the aggressiveness he was known for as Deputy Prime Minister. In his first six months he has ordered a complete review of the country's tariff system, begun a war on corruption in the civil service, retained pro-US technocrat Musa Hitam as his deputy to reassure a nervous foreign business community, created a national marketing company for Malaysian exports modeled after Japanese trading houses, and given his ministers one year to achieve results in improving the efficiency of the bureaucracy. [redacted] Petronas cut oil prices to turn back weakening export sales and announced upward revisions in official estimates of oil and gas reserves to justify ambitious plans for increases in production. [redacted]

Friction With Foreigners

Mahathir holds foreigners—especially the United States—reponsible for Malaysia's current external payments slump. Since assuming office he has frequently railed against what he perceives to be "reactionary forces" in the industrialized world. Partly in response to domestic political pressures, he has taken the United States to task for its votes in international commodity forums against increases in price supports for natural rubber and tin. Kuala Lumpur is also unhappy with the US decision last October not to join the Sixth International Tin Agreement. It formally protested when the US General Services Administration began sales from its tin stockpile last December to finance acquisition of other important metals. [redacted]

Decisive efforts to gain control over domestic rubber and tin production have accompanied Mahathir's public statements. Last September Permodalan Nasional Berhad (PNB), a government holding company for Malay corporate equity, paid two to four times the market price for 8 million shares of Guthrie, a British multinational firm that controls 81,000 hectares of Malaysian rubber plantings. The acquisition took place during an unannounced four-hour blitz on the London Stock Exchange, and British investors protested the move as "backdoor nationalization." Two other British plantation enterprises were subsequently acquired in the same manner. When the stock exchange adopted a rules change to prevent future raids, Kuala Lumpur interpreted the move as anti-Malaysian and retaliated swiftly. Mahathir ordered a reexamination of government purchases of British goods, an order his overzealous bureaucracy implemented as a full-fledged embargo. It could cost British firms over $60 million in nonmilitary export sales this year. [redacted]

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Government efforts to "Malayanize" domestic tin reserves have been nearly as dramatic. Last fall Kuala Lumpur formed the world's largest tin company by merging two private firms in which PNB held substantial equity and by buying 20 percent of a British tin multinational to achieve complete control over Malaysia's tin smelting capacity. The government, rather than Malaysian private interests, now controls nearly 40 percent of free world tin output. [redacted]

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Table 2

Malaysia's Tin Gambit: A Scorecard

The Players	Significance
Malaysian Mining Corporation (MMC)	World's largest tin company. Formed mid-1981 from several existing domestic firms with help of Malaysian Government.
Maminco	Private Malaysian marketing firm conducting price support operation through brokers. Formed mid-1981.
Permodalan Nasional Berhad (PNB)	A Government of Malaysia holding company for ethnic Malay equity in the private sector. Owns 55 percent of MMC.
Marc Rich	Zurich commodity broker. Manages intervention for Maminco on London Metals Exchange.
The United States General Services Administration (GSA)	Holder of 200,000-ton stockpile, equivalent to one year's free world production. Began reducing stocks last December via international market sales apparently to the surprise of the Malaysian Government. GSA's stockpile makes a tin cartel difficult.
International Tin Council (ITC)	Forum in which signatories of Fifth International Tin Agreement decide price band for tin. Manages own buffer stock.
London Metals Exchange	Spot and futures markets for tin and other metals. In January 1982 began an investigation into unusual divergence between spot and futures market prices. In early February adopted rules change making intervention more risky.
Mahathir Mohamad	Malaysian Prime Minister. Initial intervention coincided with his taking office in July 1981. MMC and Maminco formed at same time. He played prominent role in creating PNB.
Malaysian ethnic-Chinese mining interests	Owners of MMC. Probable owners of Maminco. Courted politically by Mahathir.
Kuwait	Possible source of financing for price support operation.
The Governments of Indonesia, Thailand, and Bolivia	Possible members of yet-to-be-formed tin cartel. Together with Malaysia, the four countries account for 83 percent of free world tin production.
Western commercial banks	Unwitting underwriters of price support operation through loans to Malaysian Government banks.

[redacted]

The government hopes that intervention in the tin market and control over rubber production will help turn around Malaysia's sagging external accounts while producing domestic political dividends. Heavily influencing the government's judgment is its belief that the Sixth International Tin Agreement will not become operational in July 1982 as scheduled for lack of ratification by consuming countries. Deputy Prime Minister Musa recently told the press that the government had already discussed the possibility of forming a cartel with Indonesia and Thailand and had plans to sound out Bolivia. [redacted] If a tin cartel is in the planning stages, Malaysia has reason to oppose further GSA stockpile sales with a special vehemence. Musa has in any case indicated that he believes US commodity policies have made such an arrangement necessary to protect producer countries. [redacted] 25X1

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Outlook for 1982

Mahathir's unhappiness with US Government commodity policies has not yet adversely affected broader US business interests in Malaysia, largely because the Prime Minister has selected his foreign targets carefully. Britain, for example, no longer has a large financial stake in its former colony, and Kuala Lumpur does not fear the economic consequences of alienating British interests. Non-British foreign investors have yet to react with great alarm over Mahathir's conduct of economic policy. Indeed for the first 10 months of 1981, foreign investment equity applications reached $457 million, about twice the level recorded in 1980. [redacted] 25X1

A resurgence in export markets that would simultaneously relieve Malaysia's external payments slump and reduce Mahathir's frustrations with foreign interests is not in the offing for 1982. The world oil market remains glutted, and weak international commodity prices are reinforcing unfavorable trends in export volumes for rubber, tin, and timber under way since 1978. The dim export outlook coincides with Mahathir's intention to hold early parliamentary elections. Unfortunately for Mahathir, in early February he was forced to announce a 20-percent cutback in domestic

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Malaysia: Creating TINPEC?

If, as appears likely, the Sixth International Tin Agreement is not ratified in April by consuming countries, some form of producers organization will take its place. Malaysian officials have been careful to avoid using the term cartel to describe the producers organization they are trying to develop. However, the potential of such an arrangement has not been lost on industry analysts or the press, which have already labeled the proposed organization "TINPEC."

Whatever form the arrangement takes, it would almost certainly include Indonesia, Thailand, and Bolivia. Of the three, Bolivia most strongly supports the idea of producer cooperation. Thailand and Indonesia so far have publicly denied any interest in a cartel but have supported, at very minimum, a marketing organization. Even Brazil, which is not yet a major exporter but has enormous undeveloped reserves, is calling for some form of producers alliance.

A tin cartel might appear feasible at first glance. The four countries that would presumably form the cartel currently produce 83 percent of the non-Communist world's tin output. Malaysia would provide 40 percent of the cartel's supplies and would thus function as dominant cartel member in the way that Saudi Arabia dominates OPEC. Malaysia would probably take the lead determining prices, backing up its decisions with its production potential. The success of a cartel is open to question, however, because of tin's high substitutability with other metals and GSA's 200,000-ton stockpile.

Even so, signs indicate the Malaysians are serious. They have already announced a unilateral cutback in domestic production to take place this summer. At 15,000 tons, the cut is 8 percent of Free World output and may be enough to firm up prices. Malaysia will take this action regardless of the production plans of the other three potential cartel members. They, in turn, will presumably reserve judgment about participating until they see how far Malaysia is prepared to go to the market in the absence of a new tin agreement.

In any case, much of the institutional machinery for a TINPEC is already in place. Maminco, a private marketing firm established in mid-1981, could handle marketing. It apparently has gained considerable experience in intervention already. Kuala Lumpur, meanwhile, has begun investigating the possibility of influencing the market by skirting the London Metals Exchange, where most tin transactions take place, and selling directly to consumers. 25X1

[redacted]

tin production—a move that may cost him considerable electoral support among ethnic Chinese at a time he badly needs it. [redacted] The impact of any further GSA tin stockpile sales will be magnified accordingly. [redacted]

Although Mahathir appears angrier than ever at Washington and has even indicated to US Embassy officials that Malaysia may deny the United States natural rubber for its strategic stockpile, he has responded to recent US efforts to defuse the tin issue by agreeing to conduct a quiet dialogue. Kuala Lumpur, however, is in an awkward position. It faces considerable financial losses should it abandon its intervention efforts entirely. On the other hand, it knows that it cannot alter the US position on GSA stockpile sales or strong US opposition to the formation of a cartel. Mahathir also realizes that he cannot criticize the United States too loudly in public without inflicting lasting damage to bilateral US-Malaysian relations. [redacted]

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The US Economic Stake in Malaysia

Interest	*Remarks*
Direct Investment	*American firms have acquired a $1.8 billion equity stake in the Malaysian economy. This amount includes $1 billion in Malaysia's oil industry alone, and embraces exploration, production, and distribution activity. Nearly matching these holdings is the US stake in Malaysia's electronics industry, mostly semiconductor operations, at $600 million. Most of the remaining $200 million is invested in other manufacturing industries.* *US firms active in Malaysia include: Exxon, Colgate-Palmolive, RCA, Motorola, National Semiconductor, and Texas Instruments.*
Bilateral Trade	*US imports from Malaysia - $2.68 billion in 1980* *Petroleum - $890 million* *Semiconductor components - $950 million* *Raw metals - $276 million* *Edible oils - $126 million*
Bilateral Trade (continued)	*US exports to Malaysia - $1.29 billion in 1980* *Chemicals - $583 million* *Electrical machinery - $210 million* *Heavy industrial machinery - $84 million* *Farm equipment - $21 million* *Scientific instruments - $16 million* *Grains - $27 million*
Finance	*US banks figure prominently in financing both Malaysia's international trade and participating in syndicated loans to Malaysian commercial borrowers. Despite rather narrow interest-rate spreads, American banks continue to find Malaysia an attractive loan market and participated heavily in over $1.6 billion in loans Malaysia negotiated in 1981. US banks active in Malaysian financing in 1981 included: Chase Manhattan, Chemical Bank, Citibank, Continental Illinois, Marine Midland Bank, Bank of America, Bankers Trust, Manufacturers Hanover, and Wells Fargo.*

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[redacted]

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At the same time, if Malaysia wishes to establish a tin producers organization, it will have to take a strong lead to induce potential members—Indonesia, Thailand, and Bolivia—to join. The governments of these nations are not yet convinced that a cartel is workable and, until the Malaysians demonstrate otherwise, are likely to remain uncommitted. [redacted]

[redacted]

[redacted]

Kuala Lumpur in the meantime appears determined to capitalize on a favorable international credit rating by spending its way back to prosperity. The 1982 budget calls for an unprecedented $2.4 billion in foreign loans to supplement $2.2 billion in domestic

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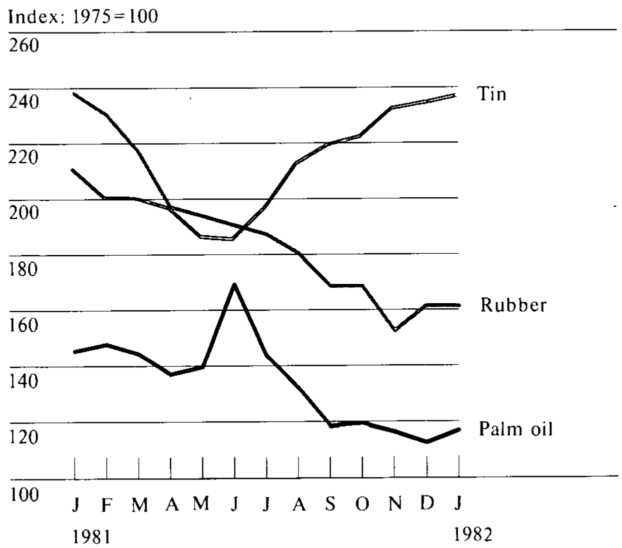
Figure 2

Malaysia: Nonoil Export Prices



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borrowing. Though its very low foreign debt service ratio of 3 percent will allow Malaysia to continue such a practice for several years, the heavy borrowing strategy carries a price. Malaysia has forfeited its coveted role as the world's most inflation-resistant LDC without permanently replacing the purchasing power lost to sagging terms of trade.

The Longer View

Conducting Malaysia's ambitious social engineering without serious clashes with foreign economic interests will be a considerably more difficult task for the government during the harsh international economic environment of the early 1980s than it was in the 1970s. Mahathir is gambling heavily that a resurgence of growth in industrial nations next year will prevent a deeper slide in Malaysia's external accounts. Although terms available to Malaysian commercial borrowers are likely to remain good through

Malaysia-US: The Spring 1982 Commodity Arena

Date	*Meeting*	*Significance*
2-5 April	*United Nations Conference on Trade and Development, International Rubber Agreement, Geneva*	*Deadline for ratification of new international rubber agreement. Probably extend deadline for another year. US a signatory, thus a supporter of Malaysian position.*
20-22 April	*International Tin Council, London*	*Producers, led by Malaysia, will request a price increase. At this time, the Sixth International Tin Agreement's poor chances of ratification will be apparent. Malaysia will hold the US largely responsible.*
28 April	*Deadline for ratification of Sixth International Tin Agreement*	*United States will not ratify the agreement.*
4-8 May	*International Rubber Council*	*Producers will request price increase. Malaysia will take lead.*

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the end of 1982, even a credit rating as good as Malaysia's could deteriorate over the longer term if private foreign bankers judge recent current account problems as lasting developments—a good possibility in view of present government budget trends. Recent rumors that a $650 million foreign loan to be syndicated during the next few months is actually meant to cover probable losses from abortive tin market intervention could inflict similar damage. At the same time, foreign investors are acutely aware that it is precisely Kuala Lumpur's ability to expand the supply of investment funds very rapidly that protects their holdings from domestic political pressures. Thus both Malaysians and foreigners—especially the United States—have a clear mutual interest in preventing the current deterioration in relations from going any further. [redacted] 25X1

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